GROWTH OF ISLAMIC BANKING

IN PAKISTAN

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INSTITUTE OF BUSINESS AND TECHNOLOGY

Growth of Islamic Banking in Pakistan

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ABSTRACT

In Pakistan Islamic banking emerged as a response to both religious and economic needs. Efforts for economy wide elimination of Riba started during 1970s and most of the significant and practical steps were taken in 1980s. The mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. In a technical sense it was the most advanced model compared to any other model being practiced anywhere in the world at that time. However that system fell apart as it did not adequately address issues such as putting in place an effective Shariah compliance mechanism, giving emphasis to capacity building, and opting for a flexible and evolutionary approach. In any case this effort provided a valuable experience that has been taken into account while formulation of SBP’s current strategy to re-launch Islamic Banking in Pakistan . Amendments in financial system to allow the issuance of new interest-free instrument of corporate financing, promulgation of ordinance to permit the establishment of Mudaraba companies and floatation of Mudaraba Certificates,

constitution of Commission for Transformation of Financial System (CTFS), and the establishments of Islamic Banking Department by the State Bank of Pakistan are some of the key steps taken place by the governments.

The initiative to re-introduce Islamic Banking in Pakistan was launched back in 2001 when the government decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the decision of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach. Furthermore it aims at building a broad based financial system in the country to enable all segments of the population to access financial services.

ACKNOWLEDGEMENT

First of all I would like to thank my ALLAH Almighty Who gave me the courage, health, and energy to accomplish my Project in due time and without Whose help this study which required untiring efforts would have not been possible to complete within the time limits.

Motivation, encouragement, guidance, corrections, advices, and overall support are the key elements required from the supervisor to write and complete a Project of a good standard and a quality within deadlines. It is a matter of utmost pleasure for me to extend my gratitude and give due credit to my supervisor DR. NOOR whose support has always been there in need of time and who provided me with all these key elements to complete my dissertation within the time frame.

Acknowledgement would be incomplete without extending my gratitude to one of my friend Mr. Asif Ali Khan, Manager Operation in Meezan Bank Limited, whose mammoth help in data collection made this study possible. Moreover, he has been supporting me enthusiastically throughout my work to make my Project ready in due time. My thanks is also due to my examiner Dr. NOOR whose valuable comments and suggestions made colossal contribution in improving my dissertation. Last but not least, I extend my thanks to my entire family for moral support and prays for my health and successful completion of my dissertation within time limits.

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1. INTRODUCTION

1.1 Introduction

The banking system in an economy works like the blood circulation system of a body. As only an efficient blood circulation system can ensure a healthy body, similarly an efficient and equitable banking system can dispense economic efficiency and justice. These basic concepts and objectives are common to any banking system whether it be conventional or Islamic. The difference lies in the methodology adopted to achieve these objectives. Conventional banking aims to meet these objectives through use of interest-based contracts while Islamic banking achieves these objectives through trade-based contracts.

The later is permissible while former is not. The clear prohibition of interest and permissibility of trade is mentioned in following Quranic verses'

وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا

'But Allah has permitted trading, and prohibited riba'

This similarity of objectives and difference in methodology of conventional and Islamic finance defines the regulatory framework required for Islamic banking system. Similarity of objectives implies that a major portion of the regulatory framework would be the same for both the systems. However, the difference in methodology to achieve the objectives requires amendments to existing regulatory system according to the Shariah principles.

This is a more pragmatic approach that helps avoid the tendency of unnecessarily reinventing the wheel. Moreover, it gives Islamic banking a

great advantage to get maximum leverage out of already existing and well-tested regulatory framework of the conventional banking

In Pakistan Islamic banking emerged as a response to both religious and economic needs. Efforts for economy wide elimination of Riba started during 1970s and most of the significant and practical steps were taken in 1980s. The mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. In a technical sense it was the most advanced model compared to any other model being practiced anywhere in the world at that time. However that system fell apart as it did not adequately address issues such as putting in place an effective Shariah compliance mechanism, giving emphasis to expertise, and opting for a flexible and evolutionary approach. In any case this effort provided a valuable experience that has been taken into account while formulation of SBP's current strategy to re-launch Islamic Banking in Pakistan.

The initiative to re-introduce Islamic Banking in Pakistan was launched back in 2001 when the government decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the decision of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach. Furthermore it aims at building a broad based financial system in the country to enable all segments of the population to access financial services In this context SBP worked on a three divided strategy for promotion of Islamic Banking

- Allow new full fledged Islamic banks in the private sector,
- Allow the conventional banks to set up Islamic banking subsidiaries
- Allow the existing conventional banks to open Stand-alone Islamic banking branches.

This time there has been a shift in the approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic

banking in Pakistan as a change management issue. As compared to our past experience our new approach provides flexibility to the IBIs *(Islamic Banking Institutions)* as regard to products, instruments and Shariah compliance methodology. This new initiative has witnessed a very encouraging response.

As at end of the year 2003 only one bank operated as a full-fledged Islamic bank and three conventional banks were operating Islamic banking branches. Currently there are 6 full fledged licensed Islamic banks (IBs) and 12 conventional banks have licenses to operate dedicated Islamic banking branches (IBBs). All of the five big banks in Pakistan are providing Islamic banking services. The total assets of the Islamic banking industry are over Rs. 313 billion as of June, 2009 which accounts for a market share of 5.1% of total banking industry assets. The market share of deposits stands at 5.2%. Total branch network of the industry comprises of more than 528 branches with presence in over 50 cities & towns covering all the four provinces of the country.

The industry over the years has managed to offer a wide array of products encompassing almost the\ entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy. Also it has been noticed that the industry has a good financial performance. Foreign investment in Pakistani Islamic banking industry is giving the industry a unique look through which success transfer is taking place as experiences are being shared leading to the development of the local industry.

SBP has over the years attempted to develop a supportive Regulatory and Supervisory Framework having special emphasis on Shariah Compliance that is in line with the best international practices. The aim is to align our industry with the international best practices so as to enhance the credibility and international stakeholders' confidence in Islamic banking efforts of SBP.

This will in turn not only boost the image of our country but will also be instrumental in attracting foreign investment. Pakistan has adopted a three

tiered, somewhat unique, Shariah Compliance Mechanism and process to ensure a deeper and extensive Shariah compliance supervision on an on-going basis.

The data for quarter ended June 2009, shows that asset financing activities of Islamic banks have revived besides substantially higher assets and deposits growth. The profitability indicators have also shown marked improvement as compared to the preceding quarter. The financing and investment portfolio of Islamic banks reached Rs 195.0 billion in June 2009 compared with Rs 185 billion in March 2009, depicting an increase of 5.1 percent during the last quarter.

In terms of market share, total assets, financing & investment and deposits reached 5.1 percent and 4.2 percent and 5.2 percent, respectively, at end June 2009. The branch network of 6 full-fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches-IBBs) increased to 528 branches in June 2009.

The State Bank of Pakistan issuing "Islamic Banking Bulletin" for the second quarter ended on June 30, 3009 said that current growth rate of Islamic banking industry has envisioned to achieve a share of 12 percent by 2012 as per Islamic banking strategy plan.

The growing depositors’ confidence is well reflected in last quarter, which shows an increase of 15.5 percent in the deposits. The deposit base of Islamic banks stood at Rs 238 billion at end-June 2009 compared to Rs 206 billion in the previous quarter-end.

Total liabilities of Islamic banks have increased by 13.3 percent to Rs 274 billion from Rs 242 billion during the quarter. While the net assets and equity increased by around 7 percent each. There is an increase of 6 percent in the reserves to one billion rupees and then appropriated profits increased by 79 percent to Rs 900 million in last quarter.

The most of the indicators of the Islamic banking in Pakistan showed reversion towards the usual high growth trend. It may be recalled that the Islamic banks also witnessed some slowdown as a result of the financial stress of recent times.

The financing portfolio has increased by 3 percent quarter on quarter basis. This is encouraging, as during the last quarter (January-March 2009) the financing had actually declined by Rs 10 billion. The resurgence in financing is accompanied by a 9.3 percent increase in investment. The increased financing may be reflecting the improving economic outlook of the country.

While, the investment has largely increased due to 3rd issuance of Ijara Sukuk. Nonetheless, there is a welcome increase of Rs 2.4 billion in Musharika financing, though Modaraba financing declined by almost 50 percent. Nonetheless, the net mark-up income increased from Rs 7.8 billion to Rs 15.4 billion-a healthy 94.0 percent growth. Non-mark up income increased by a hefty 213.2 percent from Rs 0.5 billion in March 2009 to Rs 1.6 billion in June 2009

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1.2 Purpose of Study

Despite slow economic activities and global financial crisis, growth rate of Islamic banking industry remained higher than the conventional banking industry, culminating in continuously rising share of Islamic finance in the local and global financial markets.

Our main purpose of the study of this topic to focus on the growth of Islamic Banking sector in Pakistan, as we came to known to know being slow economic activities Islamic banking sector grow more than the conventional banking sector in Pakistan, we will highlight the growth in all aspects, growth in Market Share, Investment, Branch network, Depositors and many more factors will be include in the study.

1.3 Research Objectives

As such, the purpose of this study is to review the various aspects of Islamic Banking and to identify the factor of growth of Islamic banking in Pakitan and also assess their viability and applicability with respect to individual and corporate consumers. More specifically the objectives will be:

- To review the History and Development of Islamic Baking in the Pakistan. This will enable the readers in understanding the evolution of Islamic Banking and will consequently enable them in evaluating its need in present times.
- To focus on the growth of Islamic banking system in Pakistan, as stated in the report of the state bank of Pakistan that Islamic banks have more growth than the conventional banks in Pakistan.
- To gauge the differences between 'interest based banking' and 'Islamic banking'. This will assist us in inferring as to whether 'Islamic Banking' does indeed protect the interests of the debtor and will highlight significant advantages and disadvantages of the two systems.
- To understand the role of government of Pakistan in the implementation of the proposed system.

- To gauge the attractiveness of Islamic Banking System for local and foreign banks. As these banks are expected to incorporate Islamic Banking in their current structure, it is essential that this option be made feasible for them.
- To ascertain corporate and individual consumer attitude towards Islamic Banking in order to evaluate its success in Pakistan. It is essential to gauge the interest of potential clients for a new product. If the potential market for Islamic Banking is insufficient to justify investment, the banks might want to develop the product further in order to make it more attractive for their clients, such as Islamic Car Financing Schemes.

1.4 Limitation of the Study

Besides the significance of this kind of study on this topic, there were several following limitations of the application of this study;

1. Limited period of time and small sample size in survey questionnaire. Results may not be indicative for the target respondents at large.
2. Some respondents, who have limited knowledge of Islamic banking or no knowledge about the financial modes of conventional and Islamic banking, also answered the questions; hence the replies of some questions may be based on their own imagination or thoughts.
3. Although majority of our respondents of Islamic banking questionnaire were account holders of Meezan Islamic Bank,

however some of our respondents had accounts in other Islamic banks too or accounts in Islamic branches of conventional banks, so the results of this study are not fully applicable to Meezan Islamic Bank of Pakistan.

Therefore, in this study the results about Islamic banking should be taken only as indicative and perceptive rather than conclusive.

1.5 Research Methodology

This research work used data collection direct from the financial Statements of the banks, both Islamic and conventional and also from the reports of State Bank of Pakistan, another source is direct from the customer of the both kinds of banks, documents researches and interviews of the relevant authorities. Fieldwork was conducted during the months of September and October of year 2009. Although all replies were collected in personnel at the allocated areas, some replies were collected after the period prescribed above. The primary data collection applied obtaining the information from peoples through filling of questionnaires, observation, and interview methods in Karachi. Local university students and friends have also helped for this work. 300 persons at Meezan Islamic bank and 300 at conventional banks in karachi were asked to express their views during this study.

2. ISLAMIC BANKING IN PAKISTAN

2.1 Growth

Islam was the basis of creation of an independent state within the undivided Indo-Pak Sub- Continent. All Constitutions of Pakistan have incorporated, within the principles of policy, the elimination of Riba as an important objective of the State policy. Quaid-e-Azam, the father of the nation, in his speech at the occasion of the inauguration of State Bank of Pakistan, had expressed the desire for evolving an Islamic system of banking. In Pakistan Islamic banking emerged as a response to both religious and economic needs.

Efforts for economy wide elimination of Riba started during 1970s and most of the significant and practical steps were taken in early 1980s. It was a very bold and comprehensive exercise. Pakistan was among the three countries in the world that had been trying to implement interest free banking at comprehensive / national level.

Numerous measures were taken to introduce interest free banking in Pakistan. Banking and other relevant laws viz. SBP Act, Companies Ordinance, recovery laws, negotiable instruments act, etc. were amended to facilitate interest free banking system and the industry was given a specific timeline to convert to the Islamic banking system.

State Bank Pakistan also gave the industry the products which it was allowed to use without any change or exception. Islamic banking was rolled out country-wide. New regulations were prepared prescribing the modes of financing, profit distribution mechanism for deposits, financing facilities by SBP, etc. which constituted ground work for Islamization of financial system. The mid-80s attempt was a significant step in the evolution of Islamic banking system in the country. In a technical sense it was the most advanced model

compared to any other model being practiced anywhere in the world at that time. The efforts and practical steps undertaken in the 1980's to Islamize the economy at national level are considered as pioneering work in the Muslim world as this became important reference material for other countries which undertook the path towards introduction and establishment of an Islamic banking system. In early 90s the whole exercise was challenged in the Federal Shariat Court and the procedure adopted by banks in Pakistan since July 1, 1985 was declared un-Islamic by the Federal Shariat Court *(FSC)* in November 1991. The system was based largely on 'mark-up' technique with or without 'buy-back arrangement'. The FSC declared that various provisions of the laws held repugnant to the injunctions of Islam in its Judgment dated November 14, 1991 would cease to have effect as from July 1, 1992.

In a meeting held on September 4, 2001 under the Chairmanship of the President of Pakistan, attended by officials of the Ministries of Finance and Law, Governor State Bank of Pakistan, Chairman and some members of the Council of Islamic Ideology and the Chairmen, and the two Task Forces it was decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions. It was also agreed that State Bank of Pakistan would offer three institutional options:

1) Setting up subsidiaries by the commercial banks for the purpose of conducting Shariah compliant transactions;

2) Specifying branches by the commercial banks exclusively dealing in Islamic products with all safeguards to ensure integrity and purity of Islamic banking operations,

3) Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.

As a result of these efforts, in 2001, an Islamic Banking Division was established in the Banking Policy Department at SBP. This time around,

concerted efforts were made by SBP to undertake Islamic Banking in its true spirit and also keeping in view the lessons learnt from the experience of Bahrain, Malaysia and Saudi Arabia etc. in this area. Accordingly, steps have been taken to set up a parallel banking system, so that an enabling environment is ensured for the sector, avoiding any serious repercussions of entire transformation of financial sector.

Shariah Compliance Developments

The present re-launch of Islamic Banking in Pakistan by the State Bank of Pakistan has been based not only on the lessons learnt from the history of Islamic Banking efforts in Pakistan but also on the experiences of other countries in the world that are currently known for their leadership role in this banking sector. The basic difference, in SBP's current policies regarding Islamic banking and the previous efforts, is the approach adopted by SBP wherein the introduction of Islamic Banking is being viewed more as a change management issue rather than as a religious or a legal issue.

This basic difference in approach defines the policies on Islamic Banking and is primarily responsible for the success achieved so far. It was decided to promote Islamic banking in a gradual manner and as a parallel and compatible system that is in line with best international practices. Following the pronouncement of the government to shift to interest free economy in a phased manner without causing any disruptions the effort was envisaged to be based on a market driven and flexible approach.

Furthermore this approach is also helping build a broad based financial system in the country to enable all segments of the population to access financial services.

Shariah compliance is the most important aspect of Islamic finance. The credibility of Islamic Banking Institutions *(IBIs)* not only depends on the financial health of the institution but also on its adherence to the Shariah.

Under the current strategy for promotion and development of Islamic Banking as a parallel, viable and compatible system, State Bank of Pakistan has put in place a comprehensive Shariah Compliance Structure.

The Shariah Compliance Framework established by State Bank of Pakistan consists of:

1. Shariah Board at SBP
2. Shariah Advisor
3. Essentials & Model Agreements of Islamic Modes of Financing Instructions and Guidelines for Shariah Compliance in Islamic Banking Institutions
4. Shariah Advisors Forum
5. Shariah Compliance Inspection
6. Standardization of Shariah Practices- Adoption of AAOIFI *(Accounting and Auditing Organization for Islamic Financial Institutions)* Shariah Standards

Each Islamic Banking Institution *(IBI)* is required to work under the guidance of a Shariah advisor. To keep this process more objective, broad based and responsive to the market conditions SBP Shariah Board has approved Fit & Proper Criteria for Shariah advisors of IBIs. According to this Criteria, minimum required Shariah and contemporary educational qualification as well as experience and exposure for becoming a Shariah Advisor has been defined. Moreover, to minimize conflict of interest, it has been specified that a person cannot work as Shariah Advisor for more than one IBI in Pakistan.

Further, it has been specified that a Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. In addition to that, Shariah Advisors of IBIs have been barred from having any substantial interest in or becoming employee of some types of organizations like exchange Companies, corporate brokerage houses or stock exchange.

These provisions in Fit and Proper Criteria for Shariah Advisors has ensured objectivity in evaluation criteria, minimization in conflict of interest and induction of new lot of Shariah advisors in the market.

Current Industry Review

This time there has been a shift in the approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue. As compared to our past experience our new approach provides flexibility to the IBIs as regard to products, instruments and Shariah compliance methodology. This new initiative has witnessed a very encouraging response. As at end of the year 2003 only one bank operated as a full-fledged Islamic bank and three conventional banks were operating Islamic banking branches. Currently there are 6 full fledged licensed Islamic banks (IBs) and 12 conventional banks have licenses to operate dedicated Islamic banking branches (IBBs). All of the five big banks in Pakistan are providing Islamic banking services. The total assets of the Islamic banking industry are over Rs. 313 billion as of June, 2009 which accounts for a market share of 5.1% of total banking industry assets. The market share of deposits stands at 5.2%. Total branch network of the industry comprises of more than 528 branches*(1)* with presence in over 50 cities & towns covering all the four provinces of the country.

The industry over the years has managed to offer a wide array of products encompassing almost the\ entire range of Islamic modes of financing that are able to cater to the needs of majority of the sectors of the economy. Also it has been noticed that the industry has a good financial performance. Foreign investment in Pakistani Islamic banking industry is giving the industry a

(1) Detail of Year wise Entry of Islamic Bank in given in ANNEXURE-A

unique look through which success transfer is taking place as experiences are being shared leading to the development of the local industry.

SBP has over the years attempted to develop a supportive Regulatory and Supervisory Framework having special emphasis on Shariah Compliance that is in line with the best international practices. The aim is to align our industry with the international best practices so as to enhance the credibility and international stakeholders' confidence in Islamic banking efforts of SBP. This will in turn not only boost the image of our country but will also be instrumental in attracting foreign investment. Pakistan has adopted a three tiered, somewhat unique, Shariah Compliance Mechanism and process to ensure a deeper and extensive Shariah compliance supervision on an on-going basis.

The data for quarter ended June 2009, shows that asset financing activities of Islamic banks have revived besides substantially higher assets and deposits growth. The profitability indicators have also shown marked improvement as compared to the preceding quarter. The financing and investment portfolio of Islamic banks reached Rs 195.0 billion in June 2009 compared with Rs 185 billion in March 2009, depicting an increase of 5.1 percent during the last quarter. In terms of market share, total assets, financing & investment and deposits reached 5.1 percent and 4.2 percent and 5.2 percent, respectively, at end June 2009. The branch network of 6 full-fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches-IBBs) increased to 528 branches in June 2009.

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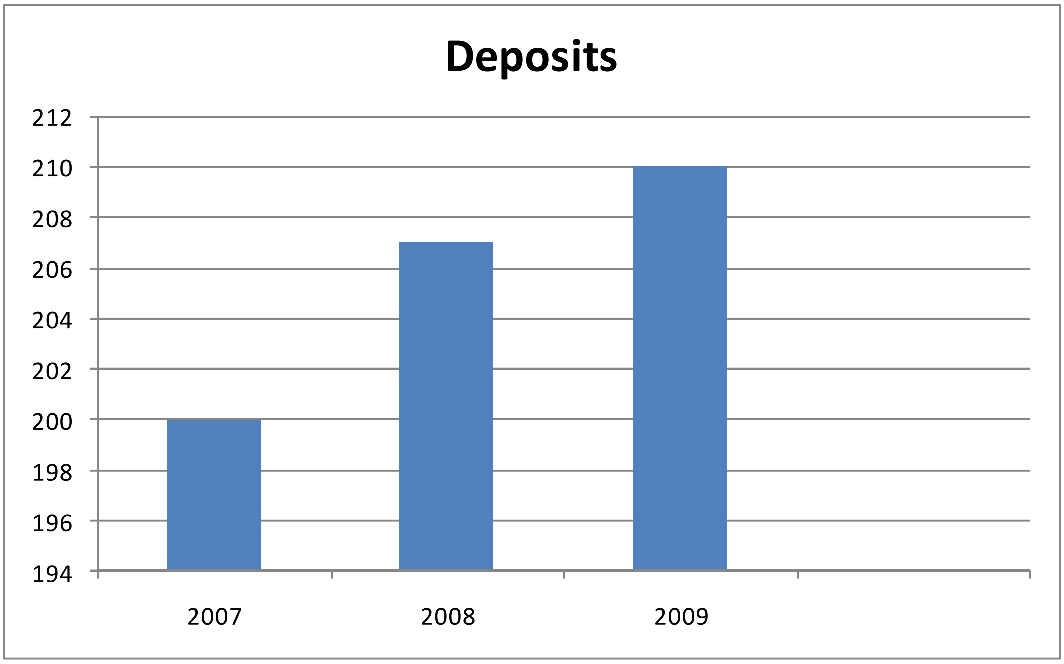
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The financing portfolio has increased by 3 percent quarter on quarter basis. This is encouraging, as during the last quarter *(January-March 2009)* the financing had actually declined by Rs 10 billion. The resurgence in financing is accompanied by 9.3 percent increase in investment. The increased financing may be reflecting the improving economic outlook of the country.

While the investment has largely increased due to 3rd issuance of Ijara Sukuk. Nonetheless, there is a welcome increase of Rs 2.4 billion in Musharika financing, though Modaraba financing declined by almost 50 percent. Nonetheless, the net mark-up income increased from Rs 7.8 billion to Rs 15.4 billion-a healthy 94.0 percent growth. Non-mark up income increased by a hefty 213.2 percent from Rs 0.5 billion in March 2009 to Rs 1.6 billion in June 2009

Islamic Finance has made commendable progress in the last few years. The growth rate remained consistently higher than the conventional finance industry, culminating in continuously rising share of Islamic finance in the local and global financial markets. The SBP is leading the way in Pakistan and has envisioned to achieve a share of 12 percent by 2012 in its Islamic banking strategy plan. A relatively restricted branch network coupled with the preferred policy of some conventional banks having IBBs *(Islamic Banking Branches)* to borrowing funds from their head offices has partly contributed to this skewed distribution.

Figure 2.1 *Deposits of Islamic Banking Industry* *(In Billions)*

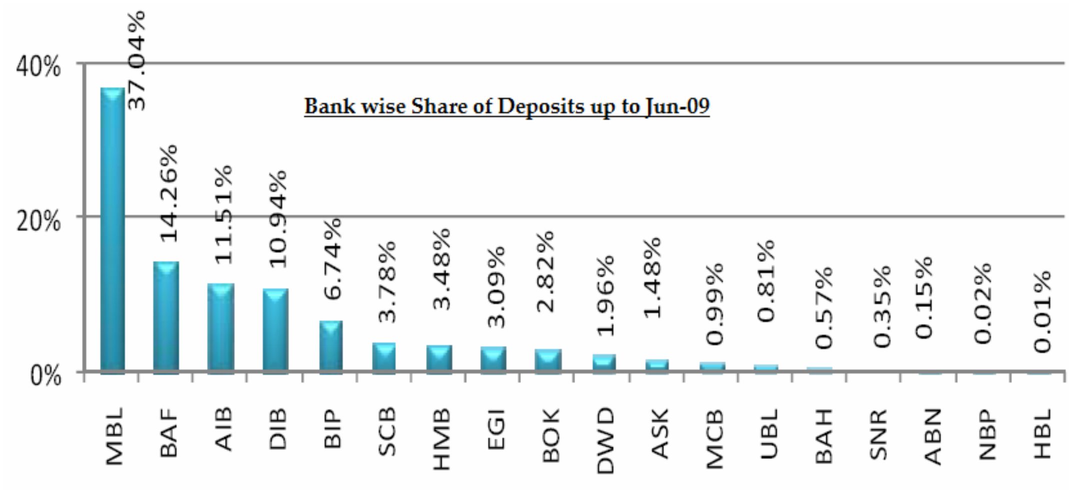


**Source: SBP Quarterly Report Jun-09*

**July 2009*

The rapid growth experienced during the year 2004 was primarily due to the entry of Albaraka Islamic bank and an aggressive strategy adopted by Bank Alfalah. Similarly the entry of four new full fledged Islamic banks i.e. Dubai Islamic, Emirates Global, Dawood Islamic & BankIslami during 2006 and 2007 contributed towards the healthy growth in overall deposits position during these years.

Figure 2.2 *Bank Wise Share of Deposits*

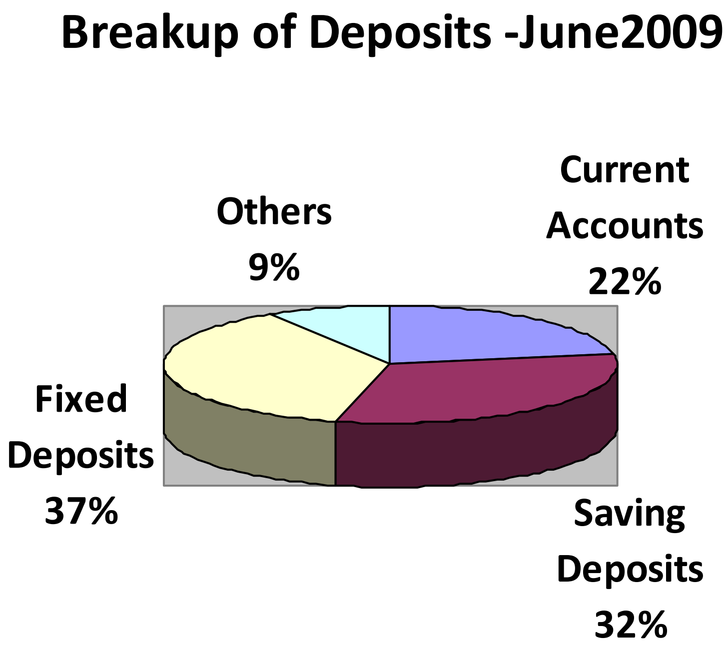


**Source: SBP Quarterly Report Jun-09*

The bank wise share of deposits as on Jun-09 is presented in the Figure. Over all the share of Meezan Bank's deposits is dominant while among IBDs (*Islamic Banking Divisions of Conventional Banks having IBBs*) of conventional banks Bank Alfalah is leading the group.

However the new entrants like Dubai Islamic and BankIslami have also managed to capture good share in relatively shorter period of time. Going forward the remaining two full fledged players i.e. Dawood Islamic and Emirates Global are also expected to catch up with other competitors.

Deposits structure consists of Fixed Deposits, Saving Deposits, Current Accounts non remunerative and other deposits. Savings, Fixed and Current account (non remunerative) of customers deposits are 32%, 36% and 20% respectively of Overall Deposits and Other accounts.



**Source: SBP Quarterly Report Jun-09*

Growth (Branch Network)

The share of full fledged Islamic banks in overall branch network of the industry has increased over period of time. Furthermore, it shows that during the year 2006 highest growth rates in overall branch expansion were experienced wherein two new full fledged Islamic banks (Dubai Islamic Bank & BankIslami) and four conventional banks having IBBs commenced operations. As the full fledged banks consolidate themselves it is expected that the rate of growth in network expansion will increase at a much higher pace.

Currently Islamic Banking is available through 6 full-fledge Islamic banks and 12 conventional banks having Islamic banking branches. The experience as reported by some of these banks is that around 10% to 15% customers walking into their branches are new to banking. These are the people that have remained away from the conventional banking system because of their beliefs. Additionally those who have been using conventional banking but

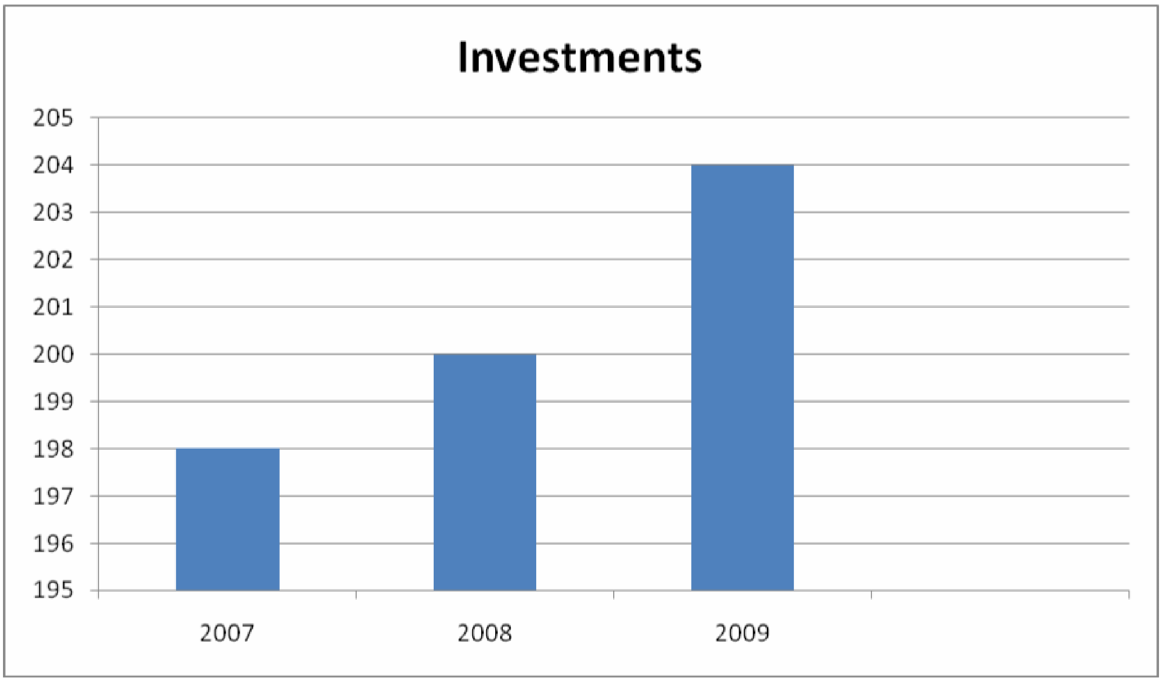
minimizing the depth of their relationship again based on their beliefs tend to deepen their relationship with an Islamic bank thus again contributing to the size of the banking sector from within its existing coverage and base. From the above figure we can identify the growth of Islamic Banking by Branch network, as this is the statistics from 2002 where there was only 6 Branches of Islamic Banks as up to June - 2009 there are 528 branches.

2.2 Investment

June-2009 the Investments has been 4.5% (194Bn) with respective to Industry' growth Initially due to non availability of Shariah compliant instruments the Islamic banking institutions suffered from a relative disadvantageous position. Specifically, until the issuance of WAPDA Sukuk in November 2005, there was no approved security for meeting the Statutory

Liquidity Requirement. Subsequently KSEW Sukuk has also been categorized as SLR eligible instrument. Meanwhile SBP has provided the industry with a level playing field through a separate SLR regime and limit on investment in shares. Currently for meeting the SLR requirements Islamic Banking Institutions have been allowed to maintain SLR at 9% of their TDL on an overall basis, with investment in SLR eligible Sukuk not exceeding 7% of their TDL *(however, individual holding in Sukuk of one issuer shall be limited to 5 percent of total TDL)* and remaining in the shape of cash in hand, balance with NBP in current account, and balance with State Bank of Pakistan in Special Deposit Account. The direct investment by the Islamic banks are not the same ratio as the conventional banks are doing, the main reason of that is the conventional banks are operating from more than decades where as the Islamic banking just had start recently by getting the full fledge licenses from the State Bank of Pakistan during 2002, from that starting point Islamic banks are now growing at the very high pace, as we have already known from the above discussion that Islamic Banking has high growth rate than the conventional banking.

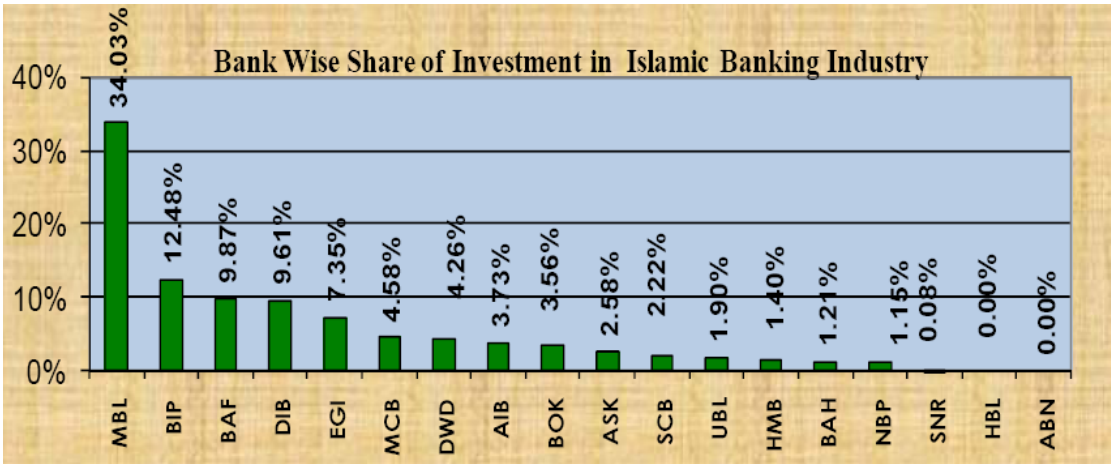
Figure 2.3 *Islamic Banking Industry Investment*



Source: SBP Quarterly Report Jun-09

**June 2009*

Figure 2.4 *Bank Wise Share of Investment - june2009*



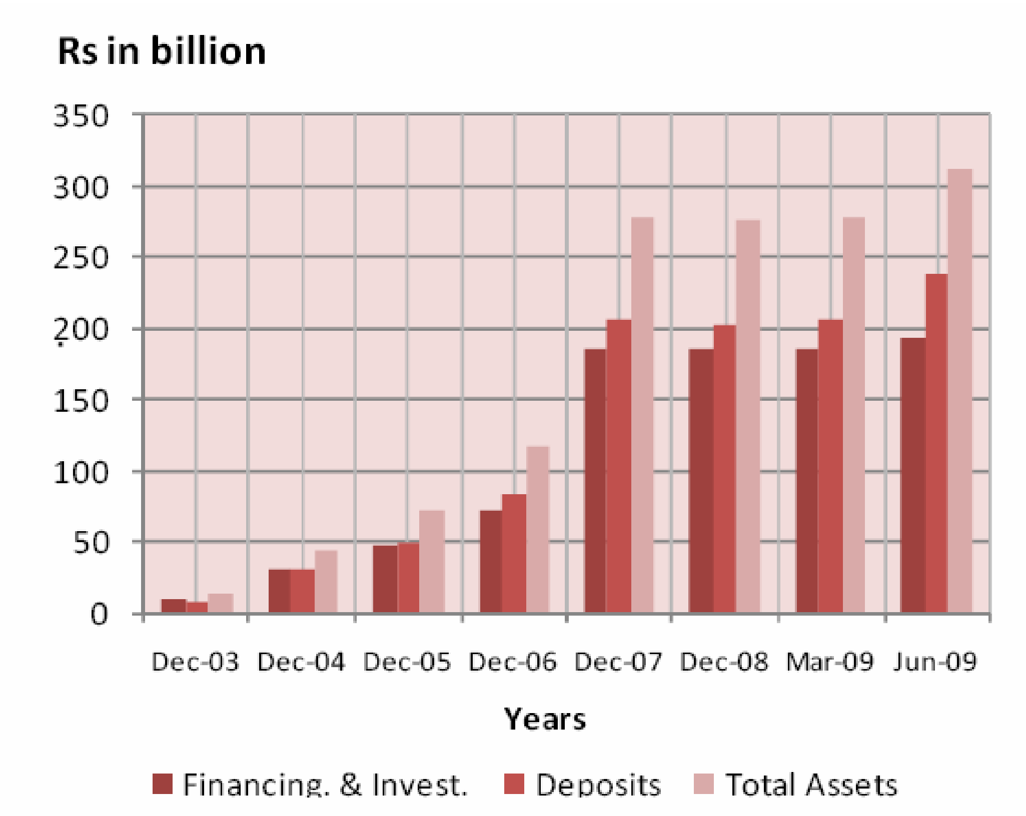
Source: SBP Quarterly Report Jun-09

Up June-2009 Meezan Bank continued to enjoy the highest share in overall investments made by the industry and Bank Alfalah in line with the size of its balance sheet leads the category of conventional banks having IBBs.

June 2009 compared with Rs.185 billion in March 2009. In terms of market share, total assets, financing & investment and deposits reached to 5.1% and 4.2% and 5.2%, respectively at end June 2009. The branch network of 6 full fledged Islamic banks and 12 conventional banks (with dedicated Islamic banking branches—IBBs) increased to 528 branches in June 2009.

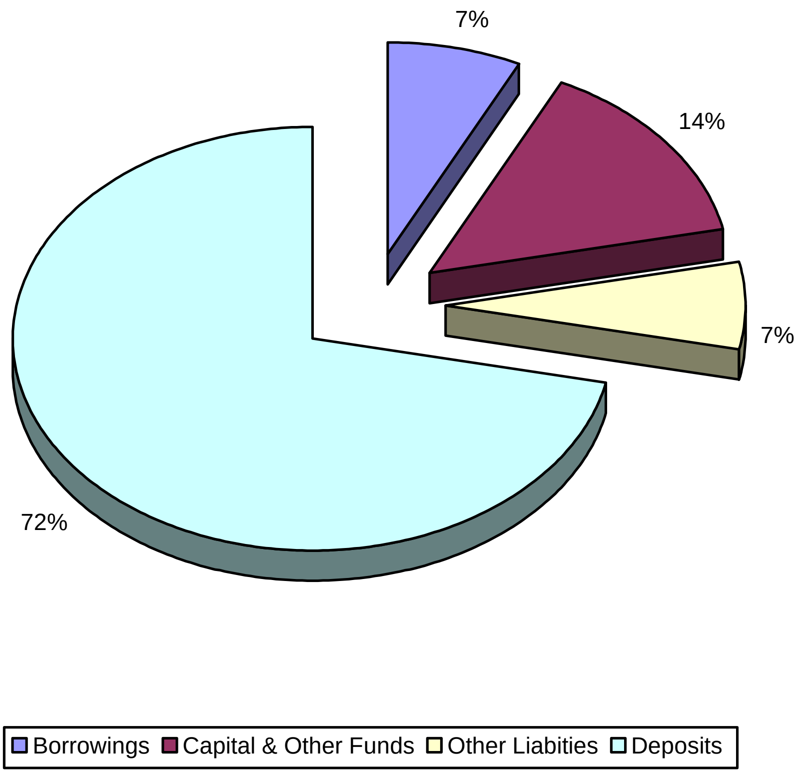
The financing portfolio has increased by 3 percent QoQ. This is encouraging as during the last quarter (Jan-Mar 2009) the financing had actually declined by Rs 10 billion. The resurgence in financing is accompanied by a QoQ 9.3 percent

Figure 2.5 *Assets of Islamic Banking Industry*



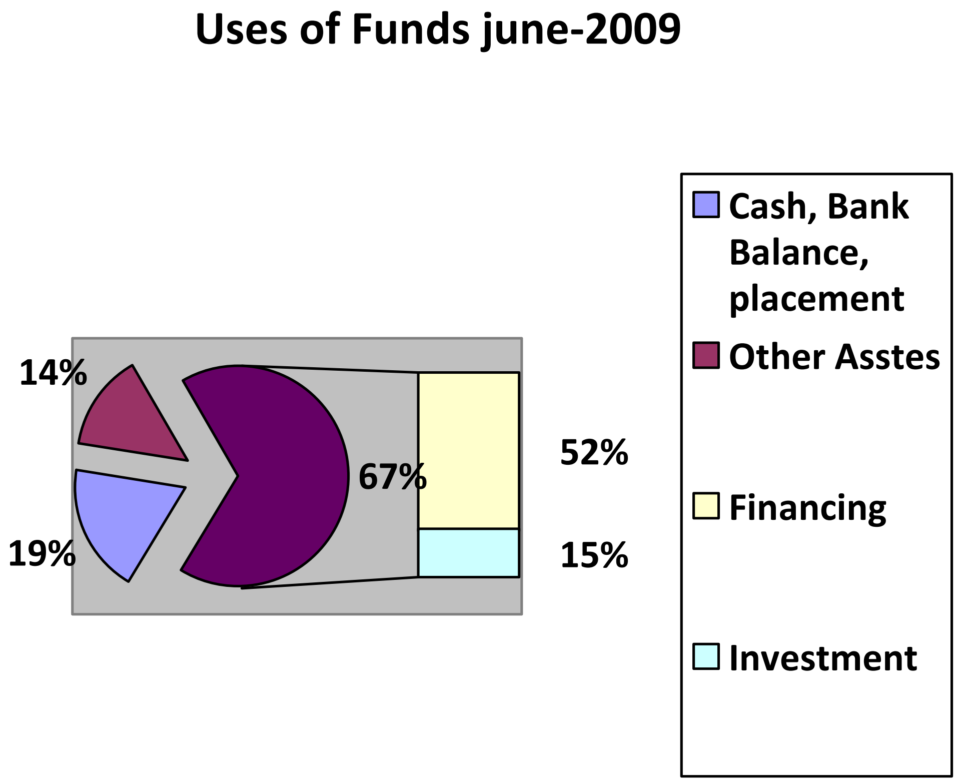
**Source: SBP Quarterly Report Jun-09*

Sources of Fund June-2009



Source: SBP Quarterly Report Jun-09

As from the above graph we van see that the main source of Funding in Islamic Baking is Customer Deposits, which contributes 72% of its total funding and remaining 7% is from Borrowing, and 14% and 7% Capital and other liabilities. From this figure it can be easily identified that the people are diversifying from conventional to the Islamic Banking.



**Source: SBP Quarterly Report Jun-09*

This figure shows the fine combination of financing and investing of the funds used by Islamic banks in june-2009, as we can easily identified that 67% of spending is done in the financing and investing section and separately financing contributes 52% and Investing 15% where as the placement portion is about 14%.

2.3 Market Share

As mentioned earlier SBP worked on a three pronged strategy for promotion of Islamic Banking i.e.

1. Allow new full fledged Islamic banks in the private sector,
2. Allow the conventional banks to set up Islamic banking subsidiaries
3. Allow the existing conventional banks to open Stand-alone Islamic banking branches.

The first and third options have been exercised so far and none of the commercial banks have so far set up a subsidiary for Islamic banking.

Figure 2.6 *Market Share*

Rupees in billion & shares in percent

	Jun 09*	Mar 09*	Dec. 08	Dec. 07	Dec. 06	Dec. 05	Dec. 04	Dec. 03
Total Assets	313	278	276	206	119	72	44	13
Share in industry	*5.1%*	*4.8%*	*4.9%*	*4.0%*	*2.8%*	*2.0%*	*1.5%*	*0.5%*
Deposits	238	206	202	147	84	50	30	8
Share in industry	*5.2%*	*4.9%*	*4.8%*	*3.8%*	*2.6%*	*1.8%*	*1.3%*	*0.4%*
Financing & Investment	194	185	186	138	73	48	30	10
Share in industry	*4.2%*	*4.3%*	*4.3%*	*3.5%*	*2.3%*	*1.7%*	*1.3%*	*0.5%*
Total Islamic Banking Institutions	18	18	18	18	16	11	11	4
Total No. of Branches**	528	524	515	289	150	70	48	17

**Source: SBP Quarterly Report Jun-09*

The change in policy approach from the legal & regulatory perspective to that of dealing with the whole affair of introducing Islamic banking in Pakistan as a change management issue has received a very encouraging response.

Under the current policy first Islamic banking license was granted on 31st January, 2002. Since then the industry has been continuously showing impressive growth. In 2003 only one bank operated as the full fledged Islamic bank and two conventional banks were operating Islamic banking branches.

The total assets of the Islamic banking industry accounted for a market share of about 0.5% and the total branch network comprised of 17 branches. Today we have 6 full fledged Islamic banks and 12 conventional banks are operating dedicated Islamic banking branches.

As on 30th June 2009, the total assets of the Islamic banking industry were around Rs. 313 billion which accounts for a market share of about 5.1%. The total branch network of the industry comprises of over 528 branches with presence in over 50 cities & towns and covering all the four provinces of the country.

It is also important to compare progress of Islamic Banking in Pakistan with the progress in other countries15. Malaysia's first Islamic Bank commenced operations in 1983 and the market share of the Malaysian Islamic banking system today stands at approximately 13%. Bahrain's Islamic banking system is said to have gained a share of around 8% in over 30 years. Similarly in Indonesia Islamic banking was introduced somewhere in mid 90's. According to Bank Indonesia, Islamic banking assets reached in March, 2009 to 1.67 percent of total assets as compared with 0.7 percent in 2003 and currently the deposits stand at 1.69% and financing at 2.60% of the total banking sector.

On the other hand, Pakistan has shown much better performance than other global players. At certain point of time, 6 full-fledged Islamic banks and 14 conventional banks with Islamic banking branches were operating. Due to merger of Habib Bank AG Zurich Pakistan Operations with Metropolitan Bank Limited and Prime Commercial Bank Limited with ABN Amro Bank N.V. Pakistan (now RBS Bank), the total number of conventional banks having Islamic banking branches today stands at 12.

Islamic banks are currently able to offer at least 75% of the product range available in contemporary conventional banking. On the consumer banking side, clean lending products like Personal Loans and Credit Cards still pose a challenge. On the corporate side working capital loans are a challenge.

None of the banks have any Microfinance or Agriculture business although a few have started offering financing to SME sector.

This offers a huge opportunity to extend the reach of the banking sector and multiply the size of Islamic banking geometrically. It also clearly points out the direction that has to be taken. In the existing coverage area, both geographical and customer type, there is need to enrich the offerings through product development and extension of distribution channel and network Additionally there is need to extend the coverage to those sectors that are not being covered by Islamic banking i.e. Microfinance and Agrifinance and also to deepen the offerings in the sector with significant potential but limited presence i.e. the SME, infrastructure and housing sectors.

it can be seen that although Islamic banks have an amount-wise 4.2% market share in financing, however, their share in number of borrowers is just 0.9%. It is because of following factors:

1. Products: 93% customers of banking industry are availing Consumer and Agriculture finance facilities. In consumer finance, a large number of customers are from the credit card or personal loan sectors. However, Islamic banks have no such products and their financing to Agriculture sector is also negligible.

2. Geographical outreach: Conventional banks have a network of more than 7800 branches in all parts of the country, through which they can extend financing. However, IBIs being new institutions have just over 582 branches (around 5.1% of total) as of end June, 2009.

3. Technical Assistance: State Bank has arranged technical assistance in the areas of SME, Agriculture, Microfinance, etc. which is being availed by conventional banks through which they are developing products for these sectors.

However, no such assistance has been provided to/availed by IBIs as yet. Despite these issues, it is believed that Islamic banking can grow at a much faster pace than conventional banking. This paper outlines and discusses in detail the specific steps to be taken.

2.4 Prospects

While the number and operations of Islamic banks are fast expanding, this segment of the market is still small relative to the appetite for Islamic finance. Pakistan, in light of its past experience, is launching a gradual and steady approach to Islamic banking. Despite rapid expansion in industry, the share of Islamic banking in the total banking system is a modest 4.0%. Moreover, it only caters for around 32,000 borrowers through around 300 branches relative to the country-wide 5 million borrowers (or 4.8 million excluding microfinance borrowers) tapped through 7,700 branches by conventional banks. Financing and investment levels of Islamic banks barely range around Rs77 billion, which is below 3% of the total banking system's advances.
On the product side, Islamic banks so far offer about 75% of products currently available in conventional banking while clean lending for consumer financing products, like personal loans and credit cards, still pose a challenge. Islamic banks operate exclusively in large cities with some now venturing into secondary cities but they are absent from rural areas where there is great potential for business growth. Global interest in Islamic finance industry and Pakistan's success in laying basic foundation and core infrastructure of Islamic financial system lends confidence that the country has good potential and prospects to further exploit this industry. Going forward, however, it is important that Pakistan adopts a more calibrated and coordinated approach and strategy for the development of Islamic finance industry.

The goal and objectives of the forward looking strategy should be to offer an alternative avenue of financial intermediation, which is competitive and promotes efficient allocation of resources in an equitable manner. Strategy should aim to supplement conventional banking industry's efforts to broaden and deepen the process of financial intermediation and financial penetration.

Islamic banking can serve as a key vehicle to improve and strength the access to development finance by bringing in financial innovation that can cater adequately to diverse demands of the population as well as corporate sector's and country's infrastructure financing requirements, while ensuring that it nurtures faith based system of financing consistent with the Shariah principles. Major elements of this strategy would require both industry and SBP to closely work together on multiple fronts. Some of the key areas of focus include: '*Aggressive deposit mobilization to augment domestic financial savings of the country'.* Although late starter, Islamic banks have phenomenal potential to exploit resource mobilization. Substantial savings have still not been channeled into the financial system because of reservations relating to interest based system or return deficiencies of the conventional system. Islamic banks, besides catering to the needs of small depositors through profit and loss sharing basic accounts with no charges, need to tap high net worth investors and companies which are increasingly being driven to the attractive options and returns being offered by more innovative players worldwide. Fast adaptation of these practices by the Islamic finance industry will be helpful in competing more effectively with conventional banks in raising deposits. Resource mobilization is critical for Islamic finance industry to grow effectively and meet the alternative requirements of economy and society

Despite these issues, it is believed that Islamic banking can grow at a much faster pace than conventional banking. This paper outlines and discusses in detail the specific steps to be taken. SBP's policies towards Islamic Banking will be:

1. Liberal for branch licensing of IBIs
2. Encouraging and supportive of IBIs in using alternate delivery channels in order to extend their outreach
3. Encouraging foreign Islamic banks to establish Islamic Banks in Pakistan
4. Encouraging the establishment of Islamic microfinance banks
5. Providing enabling environment for IBBs of conventional banks to convert into Islamic banking subsidiaries.

To achieve the target market share of 12%, an increase in coverage of the existing banking segments and entry into new segments of microfinance, agriculture, infrastructure and SME finance will be targeted

.

Based on the above direction of SBP's policy and feedback from the industry, following forecast for the industry has been developed:

Figure 2.6 *Annual Growth* (In Million)

	2008	**2009**	**2010**	**2011**	**2012**
Expected Deposit Size	215,938	340,128	499,036	722,109	907,064
Annual Growth Rate	-	**58%**	**47%**	**45%**	**26%**
Expected Financing Size	184,641	277,153	413,594	600,014	731,591
Annual Growth Rate	-	**50%**	**49%**	**45%**	**22%**

**Source: Islamic Banking Review 03-07 SBP*

It is forecasted that by 2012 Islamic banking deposits will reach in the range of Rs. 900-1000 billion and financing in the range of Rs. 700-800 billion. The growth rates of these deposits are expected to be in the range of 45-60% in next three years. Thereafter the growth is expected to be around 25% as the market would mature having a larger base and greater competition with the conventional counterparts. The IBIs are expected to achieve this target on the basis of channelizing funds from huge untapped markets and supportive role of SBP in regulations and allowing opening of branches in new business places. SBP will follow relatively liberal branch expansion policies for Islamic banking or at least at par with conventional banking. Based on SBP's projections and the feedback from the industry, following are projections for expansion in the branch network:

Figure 2.7 *Branches Growth Rate*

Year	2008	2009	2010	2011	2012
Total No. of Branches	436	655	939	1,205	1,351
Annual Growth Rate	-	50%	43%	28%	12%

**Source: Islamic Banking Review 03-07 SBP*

The IBIs in the next three years will expand their branch network at a faster pace. However, after the year 2011, the growth in branch network is expected to settle down. Although this is an ambitious plan however the industry is comfortable with it and it is also in line with the aspirational market share.

To increase the outreach of Islamic banking offerings, the industry will be encouraged to enter the Microfinance and Agriculture sectors, in addition to the SME sector. Some Islamic banks are already focusing on the SME sector and getting a good response from customers. The basic approach to entering these segments would be to maximise the leveraging of the existing conventional banking infrastructure and introducing Islamic banking products through these. SBP will introduce the Shariah compliance mechanism and segregation of Islamic banking business on the balance sheet and income statements. The specific steps planned for each of these sectors will be as follows:

Microfinance:

The central bank will use the conventional Microfinance strategy and focus more on adding the aspects peculiar to Islamic banking. As a first step, SBP has already issued guidelines for offering Islamic Microfinance Services. According to these guidelines various types of institutional arrangements have been suggested for provision of Islamic microfinance services which include

1. Establishing full-fledged Islamic Microfinance Bank (MFB)
2. Islamic microfinance services by full-fledged Islamic Banks
3. Islamic microfinance services by Conventional banks
4. Islamic microfinance services by Conventional Microfinance Banks

For each type of arrangement, a detailed framework has been provided outlining the systems and controls to be adopted and application procedure as well as different options available to banks/MFBs by which Islamic microfinance services can be offered. Going forward help will be provided to the banks offering Islamic microfinance for developing products through joint forums of experts from SBP as well as the participating banks. Incremental volumes for Microfinance will therefore be ensured. At the same time some conversion is also expected to take place.

Recently announced Microfinance strategy envisions 3 million borrowers by year 2010. It is expected that around 4-5 percent of the borrowers will be using Islamic microfinance facilities. SBP expects that growth in Islamic microfinance will pick up gradually as Islamic banks will expand to new areas after consolidating their position in core sectors like corporate and consumer finance. Moreover, establishment of dedicated Islamic microfinance bank(s) and introduction of Islamic microfinance services by conventional MFBs will give a boost to the sector. The estimated market size has been forecasted as follows:

Figure 2.8 *Microfinance*

Microfinance	2008	2009	2010	2011	2012
Expected Volume	10	100	500	1000	2000
% of Islamic Banking Financing	0.01%	0.04%	0.1%	0.2%	0.3%
Annual Growth Rate	-	900%	400%	100%	100%

**Source: Islamic Banking Review 03-07 SBP*

Agriculture

SBP's approach would remain the same as that for other development finance sectors. A task force has been constituted that consists of experts from participating banks and SBP. This committee is in the process of developing products that can be offered by banks undertaking Agriculture credit. These products are expected to be operationally ready by the end of the year. Meanwhile SBP will be issuing guidelines and then regulations for this sector. Keeping in view the inclination of end users for getting finance through Shariah-compliant products, scope of this market is huge; SBP expects the following volumes from this sector:

Figure 2.9 *Expected Agricultural Growth*

Microfinance	2008	2009	2010	2011	2012
Expected Volume	370	1400	4100	12000	21000
% of Islamic Banking Financing	0.2%	0.5%	1%	2%	3%
Annual Growth Rate	-	278.4%	193%	193%	75%

**Source: Islamic Banking Review 03-07 SBP*

3. PROBLEMS AND ISSUES

3.1 Taxation Issues

SBP has put in place a process that is comprehensive and provides the necessary groundwork to all the government departments concerned to enable them executing their part of the change in rules. This process consists of forming a committee at ICAP that determines the accounting treatment of Islamic transaction modes.

Based on the accounting treatment, changes needed in the tax rules to provide same effective taxation treatment to Islamic transactions as that provided to conventional transactions are made. SBP initially took up the issue of double taxation on Murabaha transactions with the Central Board of Revenue (CBR) and proposed amendments in the taxation laws in consultation with market players so as to provide a level playing field to the IBIs. Consequently, in the budget for the year 2004-2005, an amendment was made *(Statutory Regulatory Order 445(1) / 2004)* in the Sales Tax Act, in terms of which goods delivered under a Murabaha financing arrangement to or by a bank or a financial institution approved by the SBP or the SECP, as the case may be, were not to be treated as Supply.

Also amendments in Income Tax Ordinance in areas like minimum turnover tax etc. have been introduced. However lately in the Finance Bill 2007 it has now been ensured that taxation of Shariah compliant Islamic banking would be treated as par with conventional banking.

3.2 Financial Reporting and Accounting Standards

In Pakistan, the regulatory financial reporting framework for the Islamic Banks (IBs) and the Islamic Banking Divisions of Conventional Banks consist of:

• The International Financial Reporting Standards (IFRS);
• The Banking Companies Ordinance (BCO), 1962;
• The Companies Ordinance (CO), 1984; and
• Various rules and regulations devised by the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP) particularly including the SBP Prudential Regulations and Banking Supervision Department-Circular-4 of 2006.

According to the SBP's recently issued Guidelines for Shariah Compliance in Islamic Banking Institutions following are the Financial Reporting and General Disclosure requirements:. IBIs shall follow financial reporting standards for Islamic modes of financing issued by the Securities and Exchange Commission of Pakistan (SECP) under the Companies Ordinance, 1984. For modes/areas not covered by these standards, IBIs are encouraged to use AAOIFI Accounting Standards Moreover in the annual report, IBIs are encouraged to disclose a) overall basis of working of profit distributed to depositors; b) break up of their financing by Islamic modes of finance; and c) remuneration of Shariah advisor. In addition, the annual report of conventional banks having Islamic Banking Branches shall include separate balance sheet and profit and loss statement of their Islamic banking operations. Additional disclosure in the form of cash flow statement of Islamic banking operations is also encouraged. It is to mention here that Institute of Chartered Accountants of Pakistan has appointed a Committee on Accounting and Auditing Standards for Interest Free Modes of Financing and Investments.

The Committee comprises experienced Chartered Accountants and experts from all relevant fields including Bankers, Lawyers, Shariah Scholars and the representatives from the regulators. The Committee is reviewing the accounting standards prepared by Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain (AAOIFI) with a view to adapt them to Pakistani circumstances and if considered necessary to propose new accounting standards. So far, the Committee has issued two Islamic Financial Accounting Standards (IFASs). Murabaha has been notified by the SECP through SRO 865 (I) / 2005 in August 2005 under section 234 of the Companies Ordinance, 1984 and accordingly it has now become a part of law for the purpose of preparation of financial statements of Banks and similar financial institutions. It was made applicable on financial statements beginning on or after January 01, 2006.

Ijarah has been notified through SRO 431 (I) / 2007 dated May 22, 2007 by the Securities and Exchange Commission of Pakistan (SECP). It was made applicable on the financial statements for the periods beginning on or after July 01, 2007.It is applicable on companies, i.e. the lessees, also. In addition, work is in progress on standards for Profit Distribution to PLS depositors, Diminishing Musharaka followed by Musharaka.

3.4 Islamic Export Refinancing Scheme

Similar to the export refinance facility available to conventional banks, in 2002 SBP started a Musharaka based Islamic export refinance scheme (IERS) for Islamic banks and stand-alone Islamic branches operating in the country. Islamic Banking Institutions (IBIs) are availing this facility under both parts of SBP's Export Finance Scheme (EFS). The framework of the IERS is based on the concept of Profit & Loss Sharing. The State Bank shares the actual profit of the Musharakah pool of the Islamic Bank. However, in case the actual profit of the pool is more than ongoing rates under conventional EFS, the excess profit so received by SBP is credited to the Takaful fund, (a reserve fund to be maintained by SBP under Islamic modes) for risk mitigation that would be used to meet future losses arising during implementation of IERS. It is interesting to observe that up till 2005 only Meezan Bank Limited was availing this facility for their clients, whereas in the FY 2007-08 four full fledged Islamic banks and two conventional banks having IBBs have availed the said facility.

3.4 Lack of Expertise

Capacity Building is another major challenge being faced by Islamic financial Industry. Proper understanding of Islamic banking services and their equal treatment vis-à-vis conventional products is vital for the practitioners in Islamic Finance Industry for product innovation and differentiation. It is, therefore, extremely important to have the people with the right kind of skills and commitment to run Islamic financial institutions. • In the wake of high growth rate experienced by IBI SBP is putting special emphasis on ensuring that adequately trained human resource is employed by the Islamic Banking Institutions. Banks are asked to provide appropriate training to the staff before getting a license from SBP.

In order to give the relevant local and international exposure to employees of Islamic Banking Department and also other departments of SBP (that are dealing with Islamic banking industry) it is ensured that appropriate training opportunities are utilized. Moreover occasionally the Islamic Banking Department of SBP conducts an internal Awareness/Training Program on Islamic Banking which helps in educating the SBP staff on Islamic Banking and Finance concepts and issues.

Also a Memorandum of Understanding has been signed between State Bank and International Centre for Education in Islamic Finance (INCEIF), Malaysia which envisages creating a strategic alliance between the two for promoting educational excellence in this field in the respective countries. Under this Memorandum of Understanding 10 scholarships for “Certified Islamic Finance Professional (CIFP)”, a distance learning program developed by INCEIF were offered to Pakistan. The candidates for the said Program were nominated by SBP from its own staff, NIBAF and Islamic banks.

Workshops like those on IFSB “Capital Adequacy Standard" and " Transparency and Market Discipline" have been organized in which participants from the local industry participate as they provide the much needed facilitation on the implementation of the said Standards in our local market. Avenues like arranging / sponsoring International Conferences, Video-Conferencing etc. have been utilized so as to contribute towards achieving the task of capacity building of the
industry. Taking advantage of visits of dignitaries, and experts in Islamic finance, special sessions are organized for the stakeholders. National Institute of Banking and Finance

Initially the National Institute of Banking and Finance (NIBAF) (training wing of the State Bank) included a Module on Islamic banking and finance in its training courses designed for State Bank Officers Training Scheme and other fresh inductees.

In view of the increasing demand for trainings in Islamic banking and finance, NIBAF designed a 3-week Intermediate to Advance level Certification Course keeping in view the practical requirements of stakeholders. The course, comprising 16 modules, was designed in consultation with Islamic banking experts and Shariah scholars from within the country and also outside. The target group comprises staff from Islamic banks, commercial banks and the Islamic Banking Branches of commercial banks operating in Pakistan. The training sessions also include group work on product development, deposit management, process of Murabaha & Ijarah pricing beside case studies regarding Securitization, Sukuk, Diminishing Musharaka (Housing finance), Murabaha and Ijarah etc. 11 courses have been conducted at NIBAF Karachi & Islamabad in which 421 out of 446 officers were awarded certificates for successful completion. The Course has registered success in terms of coverage, training delivery, coordination and administration. This course, in the short run is proving to be very beneficial for the rapidly growing Islamic Banking Industry requirements. The participants are evaluated for each module and at the end there is a comprehensive test. Only participants scoring above the threshold level i.e. 60percent in each of the modules and the comprehensive test with 65percent overall weighted score are awarded certificates.

Also an international course on Monetary and Fiscal Policies with a focus on Islamic Economics has been conducted in collaboration with Islamic Research and Training Institute (IRTI) of Islamic Development Bank (IDB). The course participants were invited from the member countries of the IDB. In the same context, to share knowledge and expertise seminars on Awqaf and Retakaful have also been held at NIBAF in collaboration with the International Islamic University Islamabad and IRTI.

Other Initiatives

Institute of Bankers Pakistan conducts seminars, training courses etc. for creating wider awareness among bankers about the conceptual and operational framework of Islamic banking. The subject of Islamic Banking and Finance has also been included in its Banking Diploma courses. The curriculum of IBP's Banking Diploma Examination has been revised and updated. They have also revised the syllabus on the subject of Islamic Banking and Finance.

A number of other educational institutions like International Institute of Islamic Economics, International Islamic University Islamabad, and Centre for Islamic Economics, Karachi, etc are also offering academic and training courses on Islamic banking and finance. SBP has developed a standardized curriculum for certification, post-graduate and master level programs in Islamic Banking. The curriculum has been sent to the Higher Education Commission (HEC). HEC's Curriculum Review/Revision Committee would in due course consider the curriculum for possible adoption in Pakistani educational institutions. This attempt will hopefully ensure up to a certain extent the quality of the offerings by education, training and research institutions offering Islamic Banking courses

3.5 Network Issues

Distribution Network: As at end of June 200 there were only around 582 licensed branches in the Islamic Banking sector in comparison with around 7800 branches on conventional side. The availability of financing through Islamic Banking is still very much limited. In this scenario SBP apart from considering liberal branch licensing policy is also encouraging the Islamic banking institutions to utilize alternate delivery channels for improving the accessibility of the Islamic banking services across the length and breadth of the country. These include the options of Islamic Banking Windows and Branchless Banking.

Islamic Banking due to its appeal among the masses because of its ethical and religious dimensions has a strong growth potential in fields like micro-financing, agriculture financing, infrastructure finance, Small & Medium Enetrprises etc. Moreover as the demand for launching of diversified and integrated Islamic financial System in the country is on the rise there is a great potential for Islamic Banking products in these areas. Till now only one or two Islamic banking branches are engaged in Islamic Microfinance services and there is a strong need for development of. this segment. However the major issue in this regard at this point of time is awareness about Islamic microfinance. Islamic banks were till recently in developmental phase and high infrastructure cost deterred them from moving into new sectors & rural areas. However now that they have passed the break even stage they can afford to explore such avenues. In this regard SBP has already issued the Guidelines for provision of Islamic microfinance services and products by financial institutions,Product Development: On the consumer banking side clean lending products like Personal Loans and Credit Cards still pose a challenge.

On the Corporate side working capital loans are a test. Similarly the industry has not yet offered duly approved product under the new SBP scheme for Long Term Financing Facility (LTFF). Lately some products in these areas have been launched by a few banks which is a good sign for development of the industry as it penetrates more sectors that are currently served only by the conventional banking sector. SBP continues to strive for charting a regulatory framework for Islamic banking that ensures adherence to Shariah principles and at the same time allows the banks to adjust their offerings in accordance with their customer needs.

3.6 Lack of Awareness

Like any other "new" concept, Islamic banking and finance is also going to take some time to be fully comprehended by the people at large. Any new product when introduced in a market will go through the natural dynamics of initially being understood by a few and with the passage of time as its need and practicability is felt and appreciated by more and more people greater efforts are employed to make it recognizable for everyone. In Pakistan the failure of implementing the Islamic banking system in its true spirit in the 1980's is another major factor that contributes to the high level of skepticism expressed by many commentators. These two factors along with many others make task of creating awareness about Islamic banking among the masses a daunting one. To address this issue, State Bank had initially conducted a successful awareness program for providers and users of Islamic banking services.

• A series of interactive seminars were held with some of the key stakeholders including the SBP staff itself. Similarly seminars were held for prospective banks, chambers of commerce, business houses, etc.

Lectures in various training and educational institutions have been also been made such as IBP and International Islamic University Islamabad, Bahria and Karachi University etc. Moreover, SBP staff participates in various talk shows and interviews on a number of TV channels. We have also tried to ensure press coverage of significant events and conferences being held in Pakistan. One part of our strategy has been to target decision makers i.e. the military and civil bureaucracy and have made regular presentations in the civil services academy and national defense and staff colleges.

Taking advantage of visits of dignitaries, world renowned scholars and experts in Islamic finance, special sessions have also been organized for all the stakeholders. Video conferences on various aspects of Islamic banking have been arranged in collaboration with Islamic Development Bank and other international institutions which are attended by the bankers, chartered accountants, academicians and the students of Islamic finance.

Islamic Banking Department's page on SBP's website gives ample information about the policies, regulatory framework and other important areas. A quarterly Islamic Banking Bulletin providing update on local as well international developments in the field of Islamic banking and finance is being published by Islamic Banking Department. Seminars on Islamic Financial Accounting Standards on Murabaha and Ijarah and the Risk Management Guidelines for IBIs have been conducted which were attended by senior executives/representatives from SECP, Islamic banking industry and SBP. Professional bankers and accountants delivered lectures on the subjects from various perspectives and these events provided an excellent opportunity to the participants to discuss the practical problems faced by them in the implementation of these standards/ guidelines.

4. RESEARCH FINDINGS

The data collected is summarized according to the numerical order of the questionnaire and analyzed according to the importance and need of the study. Some of the questions are analyzed in details and some of are not due to the requirement of the study.

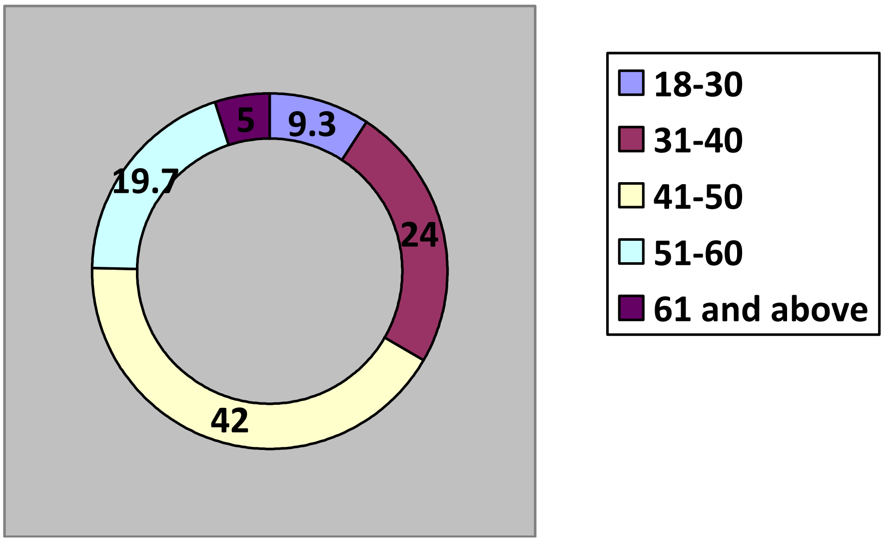
4.1 Customer Preferences

Demographic Profile of the Respondents

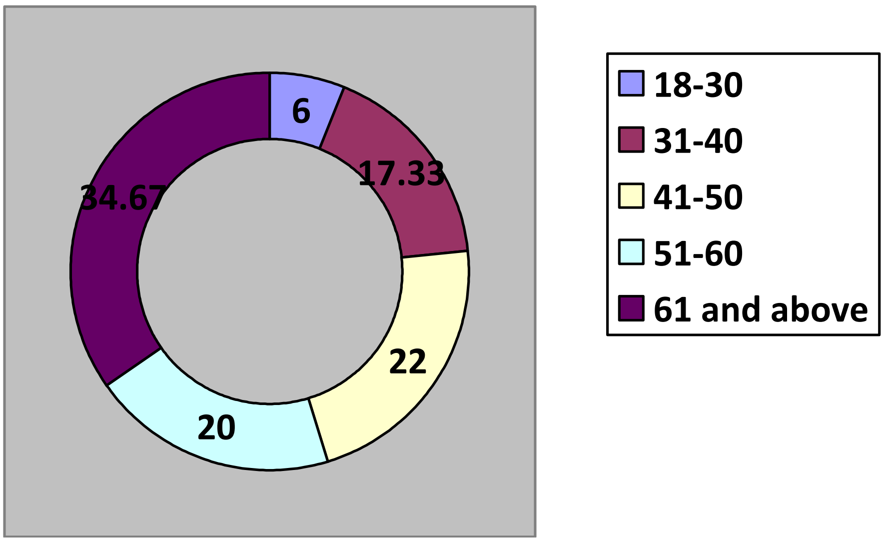
Age distribution of the respondents. (*300 responses from each bank*)

Age Group	I. B. responses	%	C. B . responses	%
18-30	28	9.3	18	6
31-40 yr	72	24	52	17.33
41-50 yrs	126	42	66	22
51-60 yrs	59	19.7	60	20
61 above	15	5	104	34.67

Age Distribution of IB Account Holders



Age Distribution of CB Account Holders



The table above contains the different age group in both Islamic Bank (I. B) and Conventional Bank (C. B). The table shows this clearly that Islamic Baking is more popular in young and middle age peoples of the society, while the conventional banks are popular in old or senior citizens of the country

Genders. *(300 responses from each bank).*

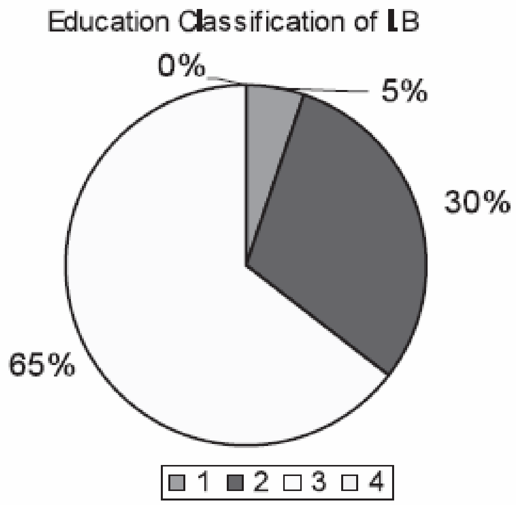
	IB Responses	%	CB Responses	%
Male	300	100	288	100
Female	0	0	0	0

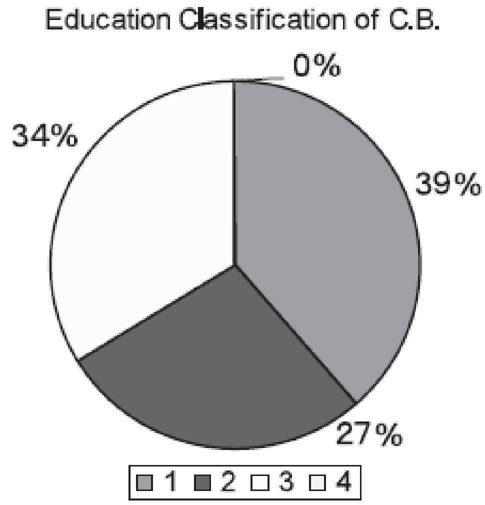
This set of distribution shows that respondents in both kind of banks were Male. During our whole stay, at different place of the projected sites, we could not meet any female respondent or account holder at Islamic Bank.

While there were some female coming in conventional Banks. This analysis shows that Islamic banks have to make the females as their target customer, so that the Islamic banking services can disburse in a balanced way.

Educational Qualifications. ***(300 responses from each bank)***

	IB Responses	%	CB Responses	%
A. High School	16	5.3	116	38.7
B. Intermediate	91	30.34	82	27.33
C. Graduate	193	64.3	102	34.0
D. Ph.d	0	0	0	0



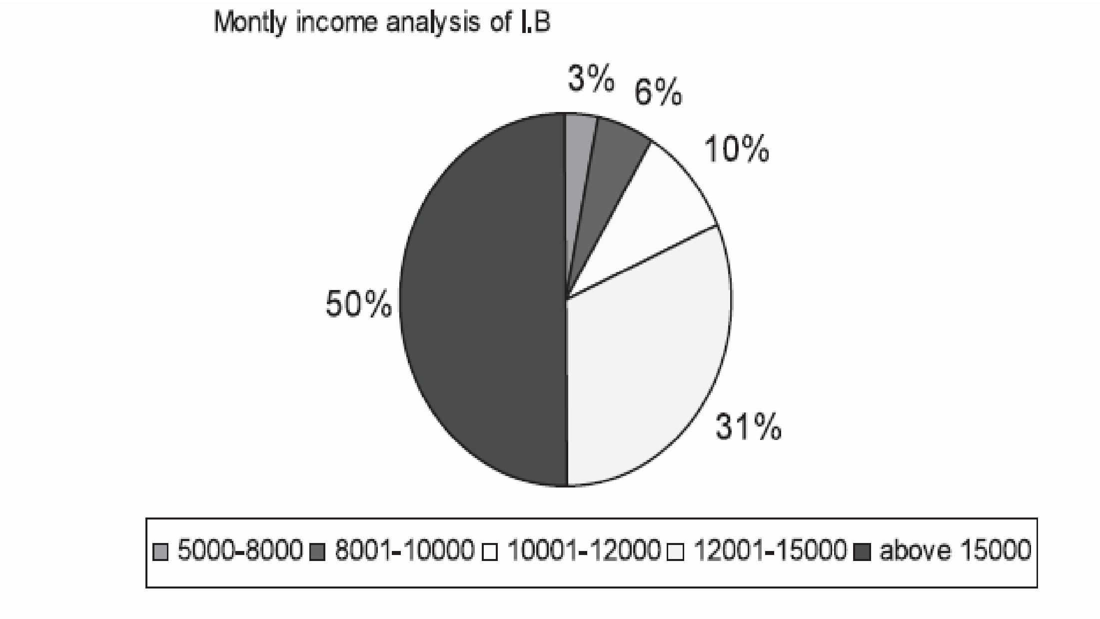


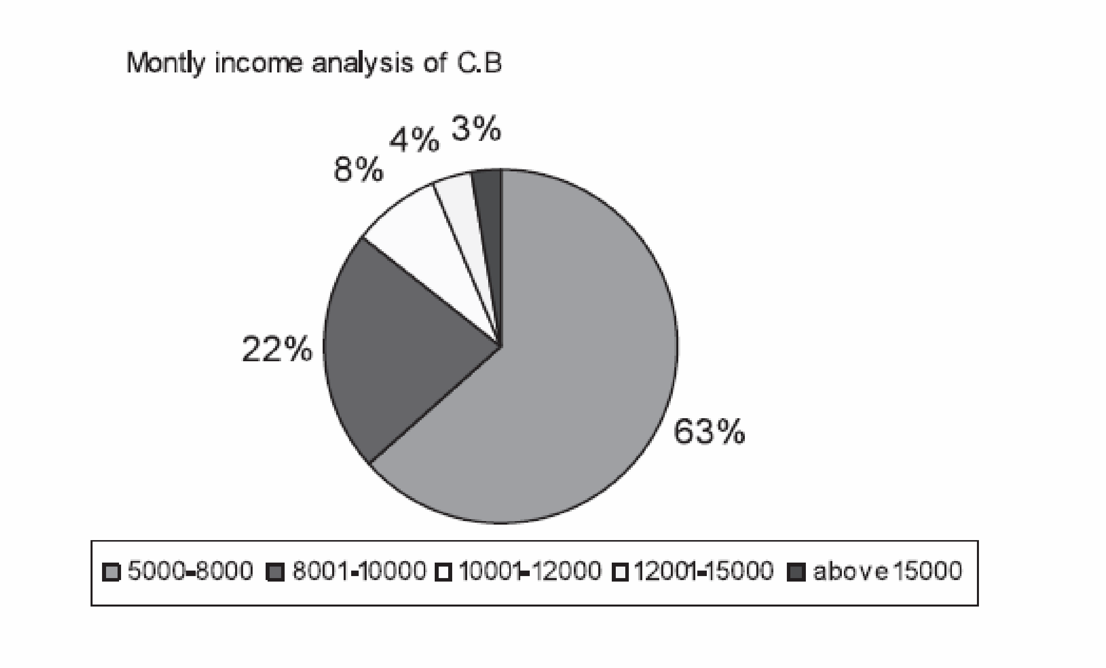
The analysis of the table 4.3 shows that Islamic banking is more popular in highly educated class of the society as compared to conventional banks. University graduates respondents of Islamic banks represent 64.3 percent as compare to the 34 percent of conventional banks respondents. While, high school graduate respondents at conventional banks are 38.67% as compare to 5.33% in Islamic Bank.

Private employees and businessmen are more in numbers in Islamic banks as compare to conventional banks. While the numbers of students and government employees are more in the conventional banks.

4.5 Monthly Incomes. *(300 responses from both banks)*

	IB Responses	%	CB Responses	%
A.5000-8000	10	3.0	190	63.33
B.8001-10000	17	5.67	67	22.33
C.10001-12000	29	9.67	24	8.0
D.12001-15000	93	31.0	11	3.67
E. More than15000	151	50.3	8	2.67





The result of table 4.5 is negative to one of the dedication of the Islamic banks i. e., to participate more in human prosperity and elimination of poverty. This result shows that Islamic banks are more popular in high-level income groups of the society, while conventional banks are more popular in low-level income groups.

4.6 For what purposes do you use this Bank?

	IB Responses	%	CB Responses	%
Investment/Saving	191	63.67	178	59.33
Borrowings	38	12.66	43	14.34
Others	71	23.67	79	26.33

(300 responses from each bank)

Table 4.6 shows that the distribution of account holders in both types of banks is symmetric. Although the purposes distribution is not very clear, yet conventional bank have more numbers of respondents at their services section

4.2 Customer's Understanding

Do you understand the key concepts of Islamic banking?

(300 responses each bank)

	IB Responses	%	CB Responses	%
Yes	**289**	**965.33**	**263**	**87.67**
No	**11**	**3.67**	**37**	**12.33**

Tabulation of above question illustrates a very interesting result. There was unexpectedly high percentage of the conventional bank account holders or visitors who were well aware of the Islamic banking concepts. On the other hand, as oppose to our expectations 11 of the Islamic bank respondents were not aware of the concepts of the Islamic banking.

This result shows that Islamic banks did not explained well the concepts of Islamic banking to their customers. And this result was of opposite to expectations, that Islamic banks enhance the awareness and education both in economic as well as religious matters and support the religious resurgence for the community

.

If you have an opportunity to open an account with Islamic bank, would you transfer your account to Islamic bank?
(300 responses from conventional bank)

	IB Responses	CB Responses	%
Yes	N/A	211	70.33
No	N/A	10	3.33
No reply	N/A	79	265.33

The table 4.8 indicates very supportive response for transfer of their financial activities from conventional bank Islamic bank.

Would you please tell us the reason for the transfer of your account ?

	I.B Responses	CB Responses	%
RIBA	N/A	126	59.72
Higher Profit	N/A	52	26.64
Other	N/A	33	15.64

Peoples want to transfer their bank dealings from conventional banks to Islamic banks because of religious background as well as higher profits as shown by the annual financial reports of both kinds of banks.

Would you continue to deal with Islamic bank even if its services charges are higher than the conventional banks?
(300 responses from each bank)

	IB Responses	%	CB Responses	%
Yes	231	77.0	194	64.7
No	13	4.3	17	5.7
No Reply	56	18.7	89	29.6

This question also shows an affectionate attachment of the people for Islamic baking. Even in the case of higher bank charges peoples are willing to continue their dealings with Islamic bank.

Do you agree ? Islamic Banks can contribute more to the societal balance, human prosperity and welfare.
(300 responses from each bank)

	IB Responses	%	CB Responses	%
Agree	226	75.3	234	89
Disagree	13	34.33	6	2.3
Don't Know	61	20.33	23	8.7

The replies of above question show that peoples in Pakistan expect that Islamic banks are more helpful for economic development, societal balance and human prosperity. It is also verdict from the injunction of Shariah rules that Islamic financial institutions are obliged to participate in the equal distribution of wealth, human prosperity and equal economic development

This research study is result of a pioneer fieldwork conducted so far on Islamic Banking in Pakistan. Therefore, the results should be taken only as indicative and perceptive rather than conclusive. It is hoped that further empirical or theoretical studies will be done to draw more definitive realities.

5. CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

The success of the present re-launch of Islamic Banking in Pakistan by the State Bank of Pakistan has been a result of careful planning and hard work. The results prove that the strategy for introduction of Islamic banking in Pakistan has worked well. The growth has been impressive by any standards. Achieving a market share of 4.5% in about 5 years in a rapidly growing banking sector is a remarkable accomplishment compared to the best in class countries. The re-launch experience has been invaluable and serves as a strong base on which the strategy has been put in place.

SBP's goal remains to establish Islamic banking in the country as a parallel banking system comparable and compatible with the conventional banking system while being Shariah compliant. SBP will now take its efforts to the next level. We will extend its outreach. This will be done by expanding the branch network in the existing banking segment and extending further into newer segments of Micro Finance, Agriculture Finance and SME Finance. SBP will strengthen the Shariah compliance mechanism by extending the membership of SBP Shariah Board and supporting it with a larger panel of internationally recognized Shariah consultants. It will further strengthen the regulatory framework by introducing guidelines for the new segments the industry will enter into. At the same time SBP will continue to build upon the existing regulatory framework through introducing standards developed by international bodies like IFSB, AAOIFI and IIFM. It will undertake a focused effort on developing human resource of this industry and would establish a center of excellence for training and education in the field of Islamic Banking and Economics.

Cross sectoral regulatory aspects will be addressed through the Joint Forum of SBP and SECP. SBP will continue to help the industry resolve its issues of taxation and liquidity management It is strongly believed that the strategy presented will not only spur the growth of Islamic Banking industry but will also provide it with the robust regulatory framework it needs to become a sustainable industry. It will help us establish as one of the leaders in Islamic banking internationally. It will also help us attract belief sensitive foreign investment.

5.2 Recommendations

This whole discussion clearly state that Islamic Banking is growing with higher rate than the Conventional Banking system in Pakistan, and according to the State Bank of Pakistan, Islamic Banking will grow more in future.

The main focus should be the Awareness, because many people in Pakistan and all around the world imagine that, Islamic Banking is as Similar as Conventional is, there is difference of Name and nothing else, Conventional Bank Called it Interest and Islamic Bank Called it Profit Sharing, therefore our main focus should be on this issue that we can make aware all of them that there is vast difference between Islamic and Conventional Banking system.

In the wake of high growth rate experienced by IBI must pay special emphasis on ensuring that adequately trained human resource is employed by the Islamic Banking Institutions. Banks are asked to provide appropriate training to the staff so that they can work in a better way.

Distribution Network must be grow, still Islamic Banks are backward than the Conventional Bank in Network Branches, main reason is that Conventional Bank is older than the Islamic Bank in Pakistan.

Though Islamic Banks have adequate growing rate in Branches but it need more and more investment to fulfill the current need of the market.

Islamic Bank should Introduce new financial products that can easily compete with the products of conventional banking and that cab attract the new customers for the Islamic Bank.

Know Islamic Banking industry is dependable on **KIBOR** they haven' t its own Bench Mark . Islamic Scholars and Shariah Advisors work to prepare there own bench mark which is according to Shariah and its full fill the obligation of Islam KIBOR its also a bench mark of conventional banks and the major misconception is that the because of this KIBOR Islamic Banking is not properly working according to shariah

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ANNEXURE-A: YEAR WISE ENTRY OF ISLAMIC BANKS

2003

1. Meezan Bank
2. Bank of Khyber
3. MCB Bank
4. Bank Alfalah

2004

1. Albaraka Islamic Bank
2. Habib Bank AG Zurich
3. Standard Chartered
4. Metropolitan Bank
5. Soneri Bank

2005

1. Habib Bank
2. Bank Al Habib

2006

1. Dubai Islamic Bank
2. Bank Islami Pakistan
3. ABN Amro N.V. (Now RBS Bank)
4. Askari Bank Ltd.
5. National Bank
6. United Bank Ltd.

2007

1. Emirates Global Islamic
2. Dawood Islamic Bank